CORRECTED

No. 16,702

In the United States Court of Appeals for the Ninth Circuit

SCHALK CHEMICAL COMPANY, a Corporation; GERALD I. FARMAN, HAZEL I. FARMAN, JOHN CARVER BAKER and PATRICIA BAKER, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

On Petition to Review the Decisions of the Tax Court of the United States

BRIEF FOR THE RESPONDENT

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BRIEF FOR THE RESPONDENT

OPINION BELOW

The findings of fact and opinion of the Tax Court are reported at 32 T.C. 879.

JURISDICTION

This petition for review (R. 70-77) involves federal income taxes. Each notice of deficiency was mailed by the Commissioner of Internal Revenue on

May 23, 1956; in Tax Court Docket No. 63853, a notice of deficiency was mailed to the taxpayer, Schalk Chemical Company, in the amount of $15,-087.22 for the taxable year 1950 (R. 6); in Tax Court Docket No. 63855, a notice of deficiency was mailed to the taxpayers, Gerald I. Farman and Hazel I. Farman in the amount of $11,589.98 for the taxable year 1951 (R. 13-14); in Tax Court Docket No. 63862, a notice of deficiency was mailed to the taxpayers John Carver Baker and Patricia Baker in the amount of $2,465.86 for the taxable year 1951 (R. 22); and in each instance within ninety days thereafter and on August 20, 1956, each taxpayer filed a petition in the Tax Court for redetermination of that deficiency under the provisions of Section 6213 of the Internal Revenue Code of 1954 (R. 6-11, 13-19, 22-27, 43). The decisions of the Tax Court were entered on July 21, 1959. (R. 67-69.) This case is brought to this Court by a petition for review filed on October 19, 1959. (R. 70-77.) Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1954.

QUESTION PRESENTED

The individual taxpayers and one Smith were the beneficiaries of a trust which owned all of the shares of the taxpayer corporation.[1] In 1948, the taxpayer-

[1] The beneficiaries (Hazel I. Farman and Patricia Baker) are sometimes referred to as the individual taxpayers or as the taxpayer-stockholders; their husbands (Gerald I. Farman and John Carver Baker) are parties to this proceeding because joint returns were filed. One of the trust beneficiaries (Evelyn Smith Marlow) is not a party.

stockholders agreed to purchase Smith's stock interest for $45,000, of which $25,000 was paid by them to Smith upon execution of the agreement, the balance of the purchase price ($20,000) being payable on termination of the trust. In 1950, the corporation voluntarily assumed the obligations of the taxpayer-stockholders under the purchase contract. In 1951, after termination of the trust, the corporation voluntarily reimbursed the taxpayer-stockholders for the $25,000 down payment together with interest from the date of payment, and the corporation also voluntarily paid the $20,000 balance of the purchase price owing by taxpayers to Smith. The corporation deducted the payments in its 1950 return,[2] and the taxpayer-stockholders failed to report the payments as income in any year. Did the Tax Court err in sustaining the Commissioner's determination that the payments made by the corporation (concededly less than its accumulated earnings) on behalf of the taxpayer-stockholders constituted dividend distributions taxable to them and not deductible by the corporation.

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[2] The corporation conceded below that $20,000 of the $45,000, representing the balance of the purchase price owing by the taxpayer-stockholders, is not deductible. (R. 56.)

STATUTE AND REGULATIONS INVOLVED

Internal Revenue Code of 1939:

SEC. 22. GROSS INCOME.

* * * *

(e) *Distributions by Corporations.*—Distributions by corporations shall be taxable to the shareholders as provided in section 115.

* * * *

(26 U.S.C. 1952 ed., Sec. 22.)

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend" when used in this chapter * * * means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made. * * *

* * * *

(g) [as amended by the Revenue Act of 1950, c. 994, 64 Stat. 906, Sec. 208(a)] *Redemption of Stock.*—

(1) *In general.*—If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemp-

tion in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

* * * *

(26 U.S.C. 1952 ed., Sec. 115.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

Sec. 29.115-1. *Dividends.*—The term "dividend" for the purpose of chapter 1 * * * comprises any distribution in the ordinary course of business, even though extraordinary in amount, made by a domestic or foreign comporation to its shareholders out of either—

(1) earnings or profits accumulated since February 28, 1913, or

(2) earnings or profits of the taxable year computed without regard to the amount of the earnings or profits (whether of such year or accumulated since February 28, 1913) at the time the distribution was made.

The earnings or profits of the taxable year shall be computed as of the close of such year, without diminution by reason of any distribution made during the taxable year. For the purpose of determining whether a distribution constitutes a dividend, it is unnecessary to ascertain the amount of the earnings and profits accumulated since February 28, 1913, if the earnings and profits of the taxable year are equal to or in

excess of the total amount of the distributions made within such year.

* * * *

A taxable distribution made by a corporation to its shareholders shall be included in the gross income of the distributees when the cash or other property is unqualifiedly made subject to their demands.

* * * *

STATEMENT

The facts as found by the Tax Court based in part upon a stipulation between the parties and upon testimony and exhibits introduced at trial may be summarized as follows (R. 42-55):

Schalk Chemical Company, organized in 1903 under the laws of the State of California, manufactures and distributes nationally a line of associated paint products and home repair products. Its books were kept and its returns filed on an accrual basis. (R. 42.)

Horace O. Smith died testate in 1928, being survived by his widow, Hazel I. Smith (now Hazel I. Farman); their three children, Evelyn Smith (now Evelyn Smith Marlow), Horace O. Smith, Jr., and Patricia Smith (now Patricia Baker); and his mother, Charlotte E. Wood. The children were minors at the time, being 15, 14, and 3 years of age, respectively. Hazel I Smith became the wife of Gerald I. Farman on August 14, 1931. (R. 43-44.)

A will contest was filed by decedent's widow which was settled by a Stipulation and Agreement dated

September 26, 1929. Pursuant to the Stipulation and Agreement and Final Decree of Distribution in the Estate of Horace O. Smith, Deceased, Los Angeles Superior Court, No. 100125, a spendthrift trust was created that came into being on December 29, 1930, for a term of 20 years, expiring on December 29, 1950. The principal asset of the trust consisted of all the then-issued and outstanding stock (100,000 shares) of Schalk. The beneficiaries of the trust were Harzel I. Smith (now Hazel I. Farman), Charlotte E. Wood, Evelyn Smith (now Evelyn Smith Marlow), Horace O. Smith, Jr., and Patricia Smith (now Patricia Baker). (R. 44.) After the death of Charlotte E. Wood prior to 1940, the children succeeding to her 12½ percent interest pro rata, and until termination of the trust on December 29, 1950, the beneficial interests were (R. 44-45):

Hazel I. Farman	50 per cent
Evelyn Smith Marlow	16 2/3 per cent
Horace O. Smith, Jr.	16 2/3 per cent
Patricia Baker	16 2/3 per cent

The declaration of the trust appointed three persons to serve successively as "supervisor", each of whom while in office was to have the equivalent of absolute power of management over the trust and the Schalk Chemical Company, including the power and right to appoint a majority (three out of a total of five members) of the board of directors of Schalk and the power and right to vote all the shares of Schalk. The first named supervisor refused to serve. The second, Curtis C. Colyear, served from 1930 until his death in 1943. The third, Horace O. Smith,

Jr., held the office until his resignation in 1948. He was succeeded by Stanley W. Guthrie, who was appointed by court order (R. 45) and who acted as supervisor for the remainder of the term of the trust. Horace O. Smith, Jr., as supervisor of the trust and director and president of Schalk from 1943 to 1948, and through officers and directors which he caused to be elected, dominated and controlled the board of directors of Schalk and in consequence dominated and controlled the management and policies of Schalk. Hazel I. Farman was a "minority director" by virtue of the terms of the declaration of trust. Gerald I. Farman was appointed a "minority director" in 1945 by Evelyn Smith Marlow and Patricia Baker, pursuant to the power to designate a director reserved to them under the declaration of trust. (R. 45-46.)

After Smith became supervisor of the trust and president of Schalk, the other beneficiaries of the trust made a number of suggestions which they thought were in the best interests of the corporation to Smith and the officers and directors of Schalk that Smith had appointed. These suggestions related in part to sales promotion, new products, advertising costs, and automatic equipment. Because of the failure of the corporation to adopt and follow many of these suggestions, controversies arose between Smith and the other trust beneficiaries. Attempts to settle these controversies by setting up an executive committee composed of Smith, Hazel I. Farman, and Gerald I. Farman (Smith's stepfather) to manage the company and by permitting Gerald I. Farman to fill the position of vice president and expediter of raw

materials, were unsuccessful. In April, 1947, Evelyn Smith Marlow and Patricia Baker filed suit to remove Smith, as supervisor of the trust. This suit and the controversy between Smith and the other beneficiaries of the trust were settled, after extended negotiations, by a settlement agreement dated January 15, 1948, resulting in the elimination of Smith's interest in and control over Schalk and the payment to Smith of $25,000 in 1948 and $20,000 in 1951. During the course of the negotiations leading to the settlement agreement, the other beneficiaries of the trust proposed that the settlement be by agreement between Smith and Schalk Chemical Company. Smith rejected their proposals that Schalk be a party to the agreement or pay any part of the money which he was demanding. He insisted upon dealing directly with the other beneficiaries. (R. 46-47.)

Provisions of the above-mentioned settlement agreement of January 15, 1948, by and between Horace O. Smith, Jr., first party, and Hazel I. Farman, Evelyn Smith Marlow, and Patricia Farman Baker, second parties, stated in part the following (R. 47-52):

> For and in consideration of the sum of $25,000 to the First Party in hand by Second Parties, receipt of said sum being hereby acknowledged by First Party, First Party agrees to sell to Second Parties jointly and severally, and Second Parties jointly and severally agree to buy from First Party, subject to the terms and conditions herein contained, upon the termination and distribution of that certain trust dated December 29, 1930 * * * all of the then right, title and

interest of First Party in and to the corpus and any accumulations thereof then belonging or distributed to First Party.

On or before thirty days after the termination of said Trust No. 1071 (which said termination date is hereby agreed as being the 29th day of December 1950), and the actual distribution by the trustee of the corpus and accumulated assets of the trust estate to the beneficiaries then entitled to received the same, Second Parties jointly and severally agree to pay to First Party the sum of $20,000 in then current funds of the United States of America, less the amount of any distribution of any type or character whatsoever, including income, made by said trustee to First Party subsequent to the date hereof and prior to the date of final distribution of the trust estate.

It is understood and agreed that this agreement shall not be intended or construed as an assignment or transfer by First Party of any present right, title or interest of First Party in or to said trust or to the corpus or income thereof, and that no transfer of any interest of First Party in or to said trust, or in or to any corpus or income therefrom, shall be made by First Party until said trust has terminated and the corpus and any accumulated income thereon shall have been distributed to First Party.

It is distinctly understood and agreed that First Party agrees to sell and Second Parties agree to buy all of the assets of said Trust No. 1071 distributed to First Party upon the termination of said trust in whatever form said assets distributable to First Party may then exist, in-

cluding cash, stocks, securities and real and personal property of every kind, nature and description whatsoever. In the event that First Party's beneficial or distributable interest in said trust shall for any reason be increased by reason of the terms and provisions of said trust agreement subsequent to the date hereof and prior to the actual distribution to First Party, such increase shall be included as a part of the property to be transferred by First Party to Second Parties hereunder.

Within five days after actual distribution by the trustee of said trust to First Party of the property herein agreed to be sold to Second Parties, or notice that said beneficial interest of First Party in said trust is ready for distribution to First Party, First Party agrees to deposit into an escrow to be opened with Security First National Bank of Los Angeles or Bank of America National Trust and Savings Association, in the City of Los Angeles, all of the property of every kind, nature and description received by First Party and agreed to be sold hereunder, together with such bills of sale, deeds, conveyances, assignments, or other instruments as may be necessary to vest title thereto in Second Parties, with instructions to deliver all thereof to Second Parties or their assignees upon the payment to First Party of the sum of $20,000.00, less the amount of any distributions made to First Party from said trust subsequent to the date hereof as hereinbefore provided. First Party shall likewise deposit concurrently in said escrow an itemized statement of any such distributions made to him by said trust and shall notify Second Parties of the opening of said escrow.

Second Parties agree within twenty-five days after the receipt of such notice to deposit into such escrow the balance of the purchase price herein provided, and upon receipt of said sum said escrow holder shall be instructed to close said escrow and distribute the remainder of said purchase price to First Party, and the property herein provided to be sold to Second Parties or their assigns, the costs and expenses of said escrow to be paid by Second Parties. Any taxes assessed against the transfer of all property to be sold by First Party hereunder shall be paid by First Party promptly when due.

Said escrow instructions shall provide that if Second Parties or their assigns fall, neglect or refuse to deposit in the aforesaid escrow, within the time and subject to the conditions herein contained, the balance remaining of the aforesaid purchase price, then all property and documents deposited by First Party in said escrow shall immediately be returned to First Party on demand and said escrow shall be terminated.

In consideration of First Party agreeing to resign as supervisor of the trust hereinbefore described and as officer and director of Schalk Chemical Company, a corporation, and of his securing the resignation of Henry O. Wackerbarth as an officer, director and attorney for said corporation, and of H. T. Rausch as a director and auditor of said corporation, the parties hereto agree to enter into a stipulation for the entry of a judgment in the action in the Superior Court of the State of California in and for the County of Los Angeles, entitled Evelyn Smith Marlow and Patricia Farman Baker, as Plaintiffs, vs. Union Bank and Trust Co. of Los

Angeles, a corporation, et al., as Defendants, and numbered 528,107 in said Count, which said stipulation is being entered into concurrently herewith.

In the event that Second Parties, their heirs, successors, or assigns, shall fail, neglect or refuse to pay the balance of the purchase price as herein provided, First Party shall be released from any and all obligation to sell, transfer, convey or assign the property herein described, and Second Parties, their heirs, successors and assigns, shall be released of any and all obligations to purchase said property or to pay to the First Party any additional moneys hereunder.

The entire purchase price for the property herein agreed to be sold by First Party to Second Parties shall be the sum of $45,000.00, less and distributions made by First Party from said trust as herein provided, and the sum of $25,-000.00 paid by Second Parties as consideration to First Party for entering into this agreement shall, in the event Second Parties, their heirs, successors or assigns, comply fully and promptly with the terms and conditions hereof, be applied towards said total purchase price.

This agreement may be assigned by Second Parties, their heirs, successors and assigns, at any time during the term hereof.

First Party agrees, immediately upon request from Second Parties so to do, to apply for and use his best efforts to secure a policy of life insurance insuring the life of First Party, in such form and with such insurance company as Second Parties may request, in the principal sum of $25,000.00 with Second Parties as joint and several beneficiaries thereunder. Second Parties

jointly and severally agree to pay the initial and all subsequent premiums and costs in connection with the securing of said policy, and immediately upon the issuance thereof said policy shall be delivered to and become the property of Second Parties, First Party assuming no liability as to the payment of premiums thereon. Any dividends on said policy shall become the property of Second Parties and no change of beneficiaries shall be made without the consent of Second Parties, First Party hereby agreeing to join in and consent to any change of beneficiaries upon request of Second Parties so to do.

Time is to be and is of the essence of this agreement.

This agreement shall inure to the benefit of the heirs, executors and assigns of the parties hereto.

At a special meeting of the board of directors of Schalk held on January 15, 1948, Horace O. Smith, Jr., presented to the board his resignation as supervisor of the trust and as an officer and director of Schalk and also the resignations of the officers and directors of Schalk whom he had caused to be elected. Resolutions were adopted accepting these resignations. (R. 52.)

On January 15, 1948, Hazel I. Farman, Patricia Baker, and Evelyn Smith Marlow paid Horace O. Smith, Jr., the amount of $25,000. Hazel I. Farman paid $15,000, and Patricia Baker and Evelyn Smith Marlow each paid $5,000. Hazel I. Farman and Patricia Baker borrowed the money to make their portions of the $25,000 payment. The promissory notes given by them for the loans were due and payable on or before January 15, 1951, and bore

interest at the rate of 5 per cent per annum. (R. 52-53.)

The board of directors of Schalk adopted a resolution on December 15, 1950, which authorized the corporation to accept an assignment of the settlement agreement as of December 29, 1950, provided Horace O. Smith, Jr., survived that date; to assume the obligations to Hazel I. Farman, Evelyn Smith Marlow, and Patricia Baker under the settlement agreement; to pay them the amount of $25,000 with interest at 5 per cent from January 15, 1948; and to pay to Smith the amount of $20,000 upon delivery to Schalk of all the property received by Smith as a distributive beneficiary of the trust. As of December 29, 1950, the date of the termination of the trust, Hazel I. Farman, Evelyn Smith Marlow, and Patricia Baker, as "First Parties" and Schalk as "Second Party" entered into an agreement where the first parties assigned to Schalk all of their rights and interests in the settlement agreement of January 15, 1948; Schalk accepted the assignment and assumed and agreed to be bound by all of the obligations of Hazel I. Farman, Evelyn Smith Marlow, and Patricia Baker; and Schalk agreed to pay them the amount of $25,000, plus interest at 5 per cent per annum from January 15, 1948. (R. 53-54.)

In February 1951, Schalk paid $20,000 for the account of Horace O. Smith, Jr., to Union Bank & Trust Company of Los Angeles, $17,364.38 to Hazel I. Farman, and $5,788.13 each to Patricia Baker and Evelyn Smith Marlow. Of such sums the amount of $2,364.38 paid to Hazel I. Farman and the amounts

of $788.13 paid to Patricia Baker and Evelyn Smith Marlow, are claimed by Schalk to represent interest at the rate of 5 per cent per annum from January 15, 1948. (R. 54.)

On February 28, 1951, Horace O. Smith, Jr., and Schalk executed escrow instructions to Union Bank & Trust Company of Los Angeles whereby the corporation deposited $20,000 to be paid to Horace O. Smith, Jr., when pursuant to court order, the bank held for the benefit of Schalk the 16,666 shares which otherwise would have been distributed to Horace O. Smith, Jr. (R. 54.)

On March 20, 1951, an order was entered in the Estate of Horace O. Smith, Deceased, Los Angeles Superior Court, No. 100125, directing that there be distributed to Hazel I. Farman 50,000 shares, to Evelyn Smith Marlow 16,667 shares, to Patricia Baker 16,667 shares, and to Schalk 16,666 shares, of the stock of Schalk. (R. 54-55.)

The net profit or loss (before taxes) of Schalk for the years 1942 through 1951 was as follows (R. 55):

Year	Net Profit or Loss (before taxes)	Year	Net Profit or Loss (before taxes)
1942	$18,170.84	1947	($32,158.67)
1943	63,280.34	1948	26,504.07
1944	77,526.87	1949	5,252.45
1945	46,867.94	1950	47,603.13 *
1946	95,030.80	1951	8,638.91

* Does not include the deductions of $45,000 and $3,697.92 which are at issue.

As of December 31, 1947, the book value of the issued and outstanding stock of Schalk was $1.33 per share. Schalk had done a considerable amount of advertising over a long period of years, and it was the consensus of its board of directors that it had established an extensive good will for its products. No amount for good will was shown on its books. (R. 53.)

Post-1913 accumulated earnings and profits of Schalk as of December 31, 1950, totaled $67,861.31. No formal dividends were declared or paid by Schalk in 1951. (R. 55.)

The Commissioner determined that the taxpayers Gerald I. Farman and Hazel I. Farman received a dividend from the taxpayer Schalk Chemical Company in the taxable year 1951 of $27,000 (3/5 of $45,000), the Farmans' shareholder interest in the corporation then being 60 per cent. The Commissioner determined that the taxpayers John Carver Baker and Patricia Baker received a dividend from the taxpayer Schalk Chemical Company in the taxable year 1951 of $9,000 (1/5 of $45,000), the Bakers' shareholder interest in the corporation then being 20 per cent. The Tax Court held that the Commissioner's determination was correct in each instance and that accordingly the taxpayers, respectively, omitted from their gross income for the taxable year 1951 an amount properly includible therein in excess of 25% of the amount of gross income reported in their returns. (R. 42-43, 55, 61-67.) The Commissioner also disallowed a deduction of $45,000 claimed by the Schalk Chemical Company in 1950 as business

expenses, and a deduction of $3,697.92 claimed by it in that year as interest. The Tax Court sustained the Commissioner's determinations. (R. 42, 60-61.)

SUMMARY OF ARGUMENT

The Tax Court correctly held that the taxpayer corporation's payments to and on behalf of the taxpayer-stockholders represented dividend distributions, not deductible business expenses. The record clearly shows, as the Tax Court found, that the payments were voluntarily made by the corporation to reimburse the taxpayer-stockholders for the $25,000 down payment they had made to purchase Smith's stock interest pursuant to their individual agreement with Smith, and to discharge the taxpayer-stockholders' personal indebtedness to Smith for the $20,000 balance of the purchase price. Taxpayers' argument is erected upon a series of self-serving assumptions which are not supported by the record and were properly rejected by the Tax Court. Their contention that the $25,000 which they paid to Smith (and for which they were later reimbursed by the corporation) was paid on behalf of the corporation in order to "protect" its business, and that the $20,000 payment by the corporation directly to Smith was made in exercise of an option to purchase Smith's interest, runs squarely contra to both the form and the substance of the transaction. As is clear from the very terms of the agreement entered into between the taxpayer-stockholders and Smith, the conduct of the parties, and the other evidentiary facts—all of which

were carefully considered by the Tax Court—the taxpayer-stockholders contracted individually to purchase Smith's stock interest for a total price of $45,000, payable $25,000 down and $20,000 upon termination of the trust in which the shares were held. The corporation's $25,000 payment to the taxpayer-stockholders merely reimbursed them for the down payment portion of the price, while its $20,000 payment to Smith merely discharged their personal indebtedness for the balance of the price.

Under well settled principles, applied by this and other courts, the corporation's payments on behalf and for the personal benefit of the taxpayer-stockholders (totaling less than its accumulated earnings) constituted dividend distributions taxable to them. And since the payments were dividend distributions, there is no basis for the corporation's claim that they are deductible as business expenses. Even assuming *arguendo* that the payments otherwise qualified for deduction by the corporation, they are not deductible in 1950 as claimed, for the payments concededly were made in 1951.

ARGUMENT

The Tax Court Correctly Held That the Payments Made by the Taxpayer Corporation in 1951 for the Personal Benefit of the Taxpayer-Stockholders, in Satisfaction of the Purchase Price Which the Latter Had Individually Obligated Themselves to Pay for Smith's Stock Interest, Were Dividend Distributions Taxable to the Taxpayer-Stockholders in 1951, No Portion of Which Was Deductible by the Corporation in 1950

Horace O. Smith, Jr., his mother, taxpayer Hazel I. Farman, and his two sisters, Evelyn Smith Marlow

and taxpayer Patricia Baker, were beneficiaries of a spendthrift trust which held all of the stock of the taxpayer Schalk Chemical Company. Until the termination date of the trust on December 29, 1950, the shares were to remain in trust and at that time distributions were to be made to the beneficiaries in accordance with their respective interests. Smith held a 1/6 interest in the trust as did each of his two sisters, the balance (½) being held by his mother. The trust provided that Smith was to have control of the board of directors and the management of the corporation. Smith's mother and his stepfather, Gerald I. Farman, also served as corporate directors by virtue of a provision of the trust. (R. 42-46.)

During the period Smith controlled the board of directors and the corporate management, 1943 to 1948, various disputes arose between him and the other trust beneficiaries regarding matters affecting the corporation such as the introduction of new products, sales promotion, improved equipment and advertising costs. After attempts to settle the disputes proved unsuccessful, suit was filed in April, 1947, by Smith's sisters to have Smith removed from control of the corporation. Shortly thereafter Smith and the other beneficiaries entered into negotiations in which Smith offered to sell his beneficial interest in the trust and resign as supervisor of the trust and as an officer and director of the corporation. Smith refused to sell his interest to the corporation but instead demanded that the other trust beneficiaries in their individual capacities purchase his interest. Ac-

cordingly, a contract was entered into between Smith as the selling party and the other three beneficiaries as the purchasing parties. (R. 46-47.)

The contract, dated January 15, 1948, provided for the sale of Smith's beneficial interest to the other beneficiaries for $45,000, of which $25,000 was to be paid on the contract date and the balance, $20,000, within 30 days of the termination of the trust. Accordingly, Smith received $25,000 from the other trust beneficiaries on January 15, 1948, which was paid in proportion to their beneficial interest. Smith then resigned as an officer and director of the corporation as did the other directors whom he had appointed. (R. 47-52.)

At the date of the termination of the trust, December 29, 1950, the purchasing parties, who were then effectively the sole shareholders of the corporation, assigned the agreement of January 15, 1948, to the Schalk Chemical Company, the latter then assuming the $20,000 balance owed Smith. The corporation also agreed to reimburse the then shareholders for the $25,000 they had paid Smith on January 15, 1948, and in addition interest from that date. In February, 1951, the corporation paid Smith the $20,000 owed him by the purchasing stockholders under the contract of January 15, 1948, and reimbursed them for the $25,000 they had paid Smith on the contract date, plus interest thereon. (R. 52-55.)

The Tax Court, after carefully considering all the evidence, held that these payments made by the corporation in 1951 were in substance and effect divi-

dend distributions to the purchasing shareholders (the individual taxpayers), who had personally obligated themselves to purchase Smith's beneficial stock interest in the corporation;[3] and that consequently the payments were taxable to the purchasing stockholders and nondeductible by the corporation. We submit that its decision is clearly correct.

A. *The taxpayer-stockholders having personally contracted to purchase Smith's stock interest, the corporation's payments of the purchase price constituted constructive dividend distributions to them*

The Tax Court's opinion fully explains the reasoning underlying its holding that in the taxable year 1951 the taxpayer-shareholders received dividends proportional to their corporate interest in the total amount paid by the corporation for the shareholders, $45,000, composed of the $25,000 reimbursement payment and the $20,000 payment satisfying their obligation to Smith. (R. 61-666.) The court below noted (R. 62) that under Section 115(a) of the Internal Revenue Code of 1939, *supra*, a dividend might be any distribution to the shareholders by the corporation out of its earnings or profits regardless of whether there is a formal declaration thereof, and irrespective of whether there is a general distribution among all shareholders. *Paramount-Richards Th.* v. *Commissioner*, 153 F. 2d 602 (C.A. 5th); *58th St. Plaza Theatre* v. *Commissioner*, 195 F. 2d 724 (C.A.

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[3] The corporation's accumulated earnings on 1951 were in excess of the $45,000 payments made on behalf of the purchasing stockholders. No formal dividends were declared in that year. (R. 55.)

2d), certiorari denied, 344 U.S. 820; *Sachs* v. *Commissioner*, 277 F. 2d 879 (C.A. 8th). The necessity for examining the true nature of a corporate distribution was recently demonstrated by this Court in *Clark* v. *Commissioner*, 266 F. 2d 698, where it was stated (p. 711):

> To constitute a distribution taxable as a dividend, the benefit received by the shareholder need not be considered as a dividend either by the corporation or its shareholders, declared by the board of directors, nor other formalities of a dividend declaration need be observed, if on all the evidence there is a distribution of available earnings or profits under a claim of right or without any expectation of repayment. * * *

Furthermore this examination requires the utmost scrutiny in cases involving closely held family corporations, such as the situation at bar. *Higgins* v. *Smith*, 308 U.S. 473; *Ingle Coal Corp.* v. *Commissioner*, 174 F. 2d 569 (C.A. 7th); *58th St. Plaza Theatre* v. *Commissioner*, 195 F. 2d 724 (C.A. 2d), certiorari denied, 344 U.S. 820.

The payments in question made by the corporation in the taxable year 1951 arose out of the settlement agreement of January 15, 1948. (R. 46, 60-61.) The Tax Court found that this agreement was between Smith as the selling party and the other beneficiaries as the purchasing party and that the corporation was in no way, formally or informally, a party thereto. (R. 58-59.) The Tax Court also found that the total purchase price to be paid Smith for the sale of his beneficial interest was "$45,000,

$25,000 of which was payable at the time of the execution of the agreement and the remaining $20,000 when the trust terminated". (R. 65.) The taxpayers' argument in this Court is directed toward overturning these findings of the lower court; their position is based upon factual conclusions directly contra to these specific findings of the Tax Court. As has been stated on numerous occasions, the findings of the trial court must be upheld unless it can be shown that they are clearly erroneous. *Helvering* v. *Nat. Grocery Co.*, 304 U.S. 282; *Commissioner* v. *Scottish American Co.*, 323 U.S. 119; *Clark* v. *Commissioner*, *supra*, p. 706. These findings are clearly supported by the evidence introduced below—there are no grounds for urging that they are clearly erroneous.

The settlement agreement of January 15, 1948, names the parties thereto as "Horace O. Smith, Jr., First Party, and Hazel I. Farman, Evelyn Smith Marlow and Patricia Farman Baker, Second Parties". (R. 47.) There is no suggestion whatever in the contract that the corporation was a party or that the taxpayers-beneficiaries were purchasing Smith's interest on behalf of the corporation.

Furthermore, Smith and the attorney representing him testified that he only considered selling his beneficial interest to the other trust beneficiaries. (R. 377-378, 434-435.) In fact, the very reason Smith would not deal with the corporation was stated at trial as being that (R. 434):

> Horace Smith controlled the board of directors, and he couldn't very well sell his interest in a non-assignable trust to the corporation for a sum of money, and ask the vote and approval of the directors that he controlled, because he did control three directors. For that reason, we wouldn't consider any sale to the corporation, of the corporation.

Since Smith held control of the board of directors at that time and would not sell his interest to the corporation, the other beneficiaries could not take it upon themselves either formally or informally to act for the corporation in purchasing Smith's interest.

The Tax Court's findings that "the parties to the settlement agreement were in fact the other beneficiaries and Smith", and that "Schalk was not a party to, and did not authorize the other beneficiaries to enter into, the agreement" (R. 58) are thus amply supported by the evidence. This is clearly a case in which one party having a beneficial interest in the shares of a corporation sold his interest to the other parties who held the balance of the beneficial interest in the corporate shares. See *Niederkrome* v. *Commissioner*, 266 F. 2d 238, 243 (C.A. 9th).

The settlement agreement provided that Smith "in consideration of the sum of $25,000" would sell as of the termination of the trust his "then right, title and interest * * * in and to the corpus and any accumulations thereof then belonging or distributed to" him (R. 47); that "On or before thirty days after the termination" of the trust the purchasing parties (the other beneficiaries) would pay Smith the sum of

$20,000 (R. 47-48); and that "the entire purchase price for the property herein agreed to be sold by the First Party [Smith] to Second Parties [the other beneficiaries] shall be the sum of $45,000 * * *" (R. 51). The Tax Court upon reviewing these contract provisions stated that (R. 61):

> It is apparent from this provision of the agreement that $25,000 was the down payment the other beneficiaries obligated themselves to make (and made) at the time of the execution of the agreement in consideration for Smith's agreement to sell them his minority stock interest at the termination of the trust.

The court below further stated that (R. 65):

> Our conclusion is that the other beneficiaries were obligated under the terms of the settlement agreement to purchase, and Smith to sell, Smith's minority interest in the stock of Schalk; that the purchase price was $45,000, $25,000 of which was payable at the time of the execution of the agreement and the remaining $20,000 when the trust terminated, * * *

The taxpayers throughout their brief claim that this finding of the Tax Court is erroneous. Their brief suggests that the settlement agreement was "skillfully drawn" and "artfully ambiguous" so that Smith could receive favorable tax treatment on the sale. (Br. 24, 26.) They even claim that a document bearing the date of September 12, 1947, sets out the true provisions of the settlement agreement of January 15, 1948 (Br. 26); the latter document, they imply, is not to be given full consideration because

"the form of the settlement was dictated by Smith and the other beneficiaries had no choice" (Br. 22). The taxpayers urge that the settlement agreement of January 15, 1948, be interpreted so that the $25,000 payment made to Smith by the other beneficiaries on the date of the agreement should be viewed as a payment for the resignation of his position, which gave him control of the corporate board of directors and management of the corporation. The balance, $20,000, taxpayers claim, should be viewed as a payment for Smith's corporate shares. (Br. 24-26.)

The taxpayers' evidence consisted of their own self-serving testimony and a document ante-dating the settlement agreement of January 15, 1948. The Tax Court's finding regarding this matter is fully supported by the testimony of Smith and the attorney who represented him in the settlement agreement of January 15, 1948. (R. 378-380, 416-417, 421-422, 447, 451.) The testimony of the party who sold his interest (Smith), together with the corroborating testimony of his attorney, fully warrant the finding of the Tax Court that Smith sold his 1/6 beneficial interest in the trust for $45,000, $25,000 of which was to be paid at the contract date and the balance of $20,000 was to be paid within 30 days subsequent to the termination of the trust. Indeed, the Tax Court's finding is demanded by the very terms of the settlement agreement itself. That agreement provides (R. 51):

> The entire purchase price for the property herein agreed to be sold by First Party to Second Parties shall be the sum of $45,000.00, less any

> distributions made by First Party from said trust as herein provided, and the sum of $25,000.00 paid by Second Parties as consideration to First Party for entering into this agreement shall, in the event Second Parties, their heirs, successors or assigns, comply fully and promptly with the terms and conditions hereof, be applied towards said total purchase price.

The taxpayers seek to overturn the Tax Court's finding on testimony that is merely self-serving and in fact in direct conflict with that presented by the party who sold his interest to the taxpayers-shareholders. Further, the taxpayers urge an interpretation of the settlement agreement that is directly refuted by express provisions of the settlement agreement. When faced with a similar contention of a taxpayer who was attempting to establish that a corporate distribution was not a dividend, the Third Circuit said (*Ferro* v. *Commissioner*, 242 F. 2d 838, 843):

> We refuse to engage in a metaphysical discussion of semantics in an endeavor to adopt a factual inference proposed by a litigant, when the judicial eye should be "case directly and primarily upon the evidence in support of those [inferences] made by the Tax Court". *Commissioner of Internal Revenue* v. *Scottish-American Investment Co.*, 1944, 323 U.S. 119, 124, 65 S. Ct. 169, 171, 89 L. Ed. 113.

See also *Woodworth* v. *Commissioner*, 218 F. 2d 719, 722-723 (C.A. 6th).

As the Tax Court held, Smith sold his beneficial interest in the trust which held the shares of Schalk

to the other trust beneficiaries for $45,000. As the Tax Court further noted (R. 58-59), the taxpayers-shareholders, and not the corporation, received the benefit of the corporation's payments of the purchase price. The taxpayers-shareholders by purchasing Smith's interest were able to participate in the corporate management and control approximately three years prior to the termination of the trust. See *Niederkrome* v. *Commissioner*, *supra*, p. 243. When the trust terminated and the trust beneficiaries became the sole shareholders of the corporation, Schalk Chemical Company satisfied the balance of the amount owed Smith by the shareholders in addition to reimbursing them for payments they had made to Smith on the underlying obligation. Clearly both the corporate payments which reimbursed the shareholders for payments they had made to Smith, $25,000, and the satisfaction of the amount still owed Smith by the shareholders, $20,000, were dividend distributions to the shareholders. *Wall* v. *Commissioner*, 164 F. 2d 462 (C.A. 4th); *Zipp* v. *Commissioner*, 259 F. 2d 119 (C.A. 6th); *Paramount-Richards Th.* v. *Commissioner*, *supra*.

1. *The $25,000 payment*

The corporation was not a party to the contract of January 15, 1948, between Smith and the other trust beneficiaries. The taxpayers concede this fact on brief. (Br. 20.) Nonetheless when the trust terminated on December 29, 1950, and the beneficiaries who purchased Smith's interest on January 15, 1948, effectively became the sole shareholders of the cor-

poration (R. 62), the purchasing stockholders purported to obligate the corporation to reimburse them for the $25,000 they had paid Smith at the date of the purchase agreement, plus interest from that date (R. 53-54). As pointed out by that Court (R. 59-60), the corporation was under no legal obligation to reimburse the shareholders for their payment. The corporation never authorized the purchase of Smith's interest, either formally or informally. The taxpayers apparently urge, as they did below, that the corporation was obligated on moral grounds to reimburse the shareholders (Br. 18-20), a contention which the Tax Court properly rejected as without merit (R. 58-59).

The $25,000 reimbursement payment made by the corporation in 1951 to the shareholders was properly characterized by the Tax Court as entirely voluntary. (R. 61.) It was a corporate distribution voluntarily paid to its shareholders to reimburse them for their own personal obligation for a benefit they had received. Such a distribution is a dividend to the shareholders. *American Properties, Inc.* v. *Commissioner*, 262 F. 2d 151 (C.A. 9th); *Greenspon* v. *Commissioner*, 229 F. 2d 947 (C.A. 8th); *58th St. Plaza Theatre* v. *Commissioner, supra; Zipp* v. *Commissioner, supra.*

2. *The $20,000 payment*

At the time the trust terminated the corporation also purported to obligate itself to satisfy the $20,000 balance of the debt owed Smith by the shareholders. The Tax Court properly upheld the Commissioner's determination that the $20,000 payment made by the corporation to Smith "constituted a distribution es-

sentially equivalent to a dividend" to the taxpayer-stockholders. (R. 63.) Payments made by a corporation to satisfy an obligation of the corporate shareholders to third parties are dividend distributions to the shareholders. This proposition has perhaps been best stated in *Wall* v. *Commissioner*, *supra*, p. 464:

> The controlling fact in this situation was that Wall was under an obligation to pay Coleman $5,000 in the tax year and that Rosedale paid this indebtedness for Wall out of its surplus. It cannot be questioned that the payment of a taxpayer's indebtedness by a third party pursuant to an agreement between them is income to the taxpayer. *Douglas* v. *Willcuts*, 296 U.S. 1, 9, 56 S. Ct. 59, 80 L. Ed. 3, 101 A.L.R. 391; *United States* v. *Boston & Maine R. Co.*, 279 U.S. 732, 49 S. Ct. 505, 73 L. Ed. 929; *Old Colony Trust Co.* v. *Commissioner*, 279 U.S. 716, 49 S. Ct. 499, 73 L. Ed. 918. The transaction is regarded as the same as if the money had been paid to the taxpayer and transmitted by him to the creditor; and so if a corporation, instead of paying a dividend to a stockholder, pays a debt for him out of its surplus, it is the same for tax purposes as if the corporation pays a dividend to a stockholder, and the stockholder then utilizes it to pay his debt.

Here the corporate funds used to satisfy the taxpayer's obligation for the purchase of Smith's interest benefited the shareholders, as held by the Tax Court, and not the corporation, as claimed by the taxpayers (R. 58-59); consequently, there can be no question but that the true nature of these payments

was a dividend to the taxpayers-shareholders so benefited. *Ferro* v. *Commissioner*, *supra*; *Zipp* v. *Commissioner*, *supra*. As the Tax Court stated (R. 66):

> When the transaction was concluded therefore the other beneficiaries were in substantially the same position they would have been in if Schalk had not assumed their obligation and had distributed to them $20,000 and they had used this money to satisfy their obligation to purchase the portion of Schalk's outstanding stock, owned by Smith, which they did not then own.

This Court has repeatedly held that the net effect of the transaction being reviewed is of the upmost importance in determining whether a corporation distribution is a dividend to the shareholders. *Pacific Vegetable Oil Corp.* v. *Commissioner*, 251 F. 2d 682; *Earle* v. *Woodlaw*, 245 F. 2d 119, certiorari denied, 354 U.S. 492; *Hirsch* v. *Commissioner*, 124 F. 2d 24. There is no question here that the net effect and substance of the transaction, whereby the corporation satisfied the shareholders' obligation, were the same as if a dividend was first issued and the shareholders personally satisfied their debt from it. Furthermore, it should be noted that the same individuals who purchased Smith's interest in their own name were able to satisfy the balance of their obligation to Smith and reimburse themselves for payments made to Smith by use of corporate funds by virtue of their complete control of the corporation. The facts show that there were sufficient earnings and profits for the corporation to have declared a dividend of $45,000 to its shareholders (R. 55), and the record contains

no suggestion whatsoever that the $20,000 paid to Smith resulted in a contraction of the corporate business because of this distribution of the corporate funds. *Ferro* v. *Commissioner*, *supra*, p. 841.

The taxpayers would have the settlement agreement of January 15, 1948, interpreted so that the $20,000 payable on the date of the termination of the trust was only an option price for the purchase of Smith's interest in the corporate shares. (Br. 33.) The argument is ostensibly an effort by taxpayers to assimilate this case to the entirely different set of facts presented in *Holsey* v. *Commissioner*, 258 F. 2d 865 (C.A. 3d), where an option held by the shareholders was assigned to the corporation. This case is plainly distinguishable. See *Zipp* v. *Commissioner*, *supra;* Rev. Rul. 58-614, 1958-2 Cum. Bull. 920. The language of the settlement agreement, upon which taxpayers rely did not convert a binding contract for the purchase of Smith's interest for $45,000 into a mere option to purchase for $20,000. In the words of the Tax Court (R. 64-65):

> This isolated provision of the settlement agreement merely restricts the remedy of Smith, in the event the other beneficiaries default and fail to pay the $20,000 balance of the purchase price, to the retention of the $25,000 down payment. Somewhat similar provisions in other contracts have been held not to give the purchaser a mere option to purchase where other provisions thereof clearly indicate that it was the intention of the parties to enter into a binding contract for the purchase and sale of property. See *Vance* v. *Roberts*, 93 Fla. 379, 118 So. 205; *Wright* v.

Suydam, 72 Wash. 587, 131 P. 239; and cf. *Rodriguez* v. *Barnett*, 333 P. 2d 402 (Cal. App. 1958). Here the settlement agreement provides that, "It is distinctly understood and agreed that First Party [Smith] agrees to sell and Second Parties [the other beneficiaries] agree to buy all of the assets of said Trust * * * distributed to First Party upon the termination of said trust * * *" and that the "First Party agrees to sell * * * and Second Parties jointly and severally agree to buy * * * all of the then right, title and interest of First Party in and to the corpus and accumulations * * * of the trust."

B. *The payments were not deductible by the corporation as business expenses*

The corporation claims that the $25,000 portion of the purchase price of Smith's interest, for which it reimbursed the taxpayers-shareholders in 1951, together with interest thereon, but which it accrued on its books in 1950, is deductible by it in 1950 as an ordinary and necessary business expense under Section 23(a)(1)(A) of the Internal Revenue Code of 1939.[4] Initially, the corporation claimed that the

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[4] SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) [as amended by Sec. 121(a), Revenue Act of 1942, c. 619, 56 Stat. 798] *Expenses.*—

(1) *Trade or business expenses.*—

(A) *In general.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, * * *

* * * *

(26 U.S.C. 1952 ed., Sec. 23.)

entire $45,000 purchase price paid on behalf of the stockholders was deductible as an expense; however, as noted by the Tax Court (R. 58), the corporation subsequently conceded that $20,000 was not an expense of its operations. The corporation's theory is that the $25,000 was paid by the taxpayers-stockholders to Smith in consideration of Smith's resignation from the board of directors, in order to "protect or promote" the corporation's business, and that the corporation was obligated to reimburse them. (Br. 10-20.) The corporation's argument here is premised on the same invalid assumptions which underly the taxpayers-stockholders' contention with respect to the taxability of the $45,000 payments in question as dividends.

Since both the $25,000 and the $20,000 payments in question were dividends to the shareholders, as we have already shown, the taxpayer-corporation is not entitled to a deduction of any portion thereof (or any interest paid thereon) as an ordinary and necessary business expense. Furthermore, even assuming *arguendo*—contrary to the terms of the purchase agreement and the Tax Court's findings—that the corporation rather than the taxpayer-stockholders purchased Smith's stock interest, the payments in question nevertheless would not qualify for deduction as a business expense of the corporation; they would then have represented nondeductible capital distributions by the corporation in redemption of Smith's shares. Moreover, even further assuming *arguendo* that the $25,000 reimbursement payment by the corporation to the taxpayer-stockholders was paid in considera-

tion for Smith's giving up his control and management of the corporation, the corporation's claim still must fail, for it has failed to meet its burden of proving that the expenditure was an ordinary and necessary business expense. *American Properties, Inc.* v. *Commissioner, supra; Greenspon* v. *Commissioner, supra; Byers* v. *Commissioner*, 199 F. 2d 273, 275 (C.A. 8th). In fact the Tax Court found to the contrary, for it explicitly stated regarding Smith's ability to manage and control the corporation that (R. 59)—

> * * * we are not convinced that the management of the corporation under Smith was incompetent and that their action was either necessary or desirable to preserve its business.

The taxpayer-corporation has failed to demonstrate ~~any error in~~ the above statement of the Tax Court is in error.[5]

In any event, the payment having been made in 1951, there is no basis for its claimed deduction in 1950 merely because the corporation in that year voluntarily and gratuitously promised to make the payment.

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[5] The Tax Court also noted (R. 61), that the interest paid to the taxpayers-shareholders, which the corporation also claims as deduction (Br. 8), fails to qualify as an interest expense, there being no indebtedness of the corporation.

CONCLUSION

For the reasons presented herein, the decisions of the Tax Court should be affirmed in all respects.

Respectfully submitted,

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